Internal Revenue
bulletin

Bulletin No. 1998–50
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8790, page 4.

Final regulations under section 6662 of the Code relate to the accuracy-related penalty.

EMPLOYEE PLANS

Rev. Proc. 98–59, page 8.

Roth IRAs; prototypes. This procedure describes the method for obtaining approval of prototype Roth IRAs (including dual-purpose IRAs) by a prototype sponsor. It also provides guidance on transitional relief for users of Roth IRAs that have not been approved by the Service.

EXEMPT ORGANIZATIONS

Announcement 98–111, page 21.

A list is given of organizations now classified as private foundations.

EMPLOYMENT TAX

Page 4.

Railroad retirement; rate determination; quarterly. The Railroad Retirement Board has determined that the rate of tax imposed by section 3221 of the Code shall be 35 cents per work-hour for the quarter beginning October 1, 1998.

ADMINISTRATIVE

REG–105170–97, page 10.

Proposed regulations under section 41 of the Code relate to the computation of the credit for increasing research activities and the definition of qualified research.

Announcement 98–109, page 20.

T.D. 8785, 1998–42 I.R.B. 5, under section 861 of the Code relating to the tax treatment of certain transactions involving the transfer of computer programs, is corrected.

Announcement 98–110, page 21.

T.D. 8784, 1998–42 I.R.B. 4, under section 274 of the Code relating to the use of mileage allowances to substantiate automobile business expenses, is corrected.

Finding Lists begin on page 24.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 3221.—Rate of Tax

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning October 1, 1998, shall be at the rate of 35 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1998, 28.6 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 71.4 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated August 24, 1998.
By the Authority of the Board

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on August 31, 1998, 8:45 a.m., and published in the issue of the Federal Register for September 1, 1998, 63 F.R. 46494)

Section 6662.—Imposition of Accuracy-Related Penalty

26 CFR 1.6662–2: Accuracy-related penalty.

T.D. 8790

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Definition of Reasonable Basis

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the accuracy-related penalty. These amendments are necessary to define reasonable basis and to make conforming changes to existing regulations. These regulations affect any taxpayer that files a tax return.

DATES: *Effective date.* These regulations are effective December 2, 1998.

Applicability date. For dates of applicability, see §§1.6662–2(d) and 1.6664–1(b)(2).

FOR FURTHER INFORMATION CONTACT: Beverly A. Baughman, 202-622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 1, 1995, the IRS issued final regulations [T.D. 8617 (60 F.R. 45661 [1995–2 C.B. 274])], relating to the accuracy-related penalty under chapter 1 of the Internal Revenue Code. Those regulations provided guidance concerning the reasonable basis standard for purposes of (1) the negligence penalty under section 6662(b)(1), and (2) the disclosure exception to the penalties for disregarding rules or regulations under section 6662(b)(1) and the substantial understatement of income tax under section 6662(b)(2). In the preamble to the final regulations, the IRS and Treasury Department requested comments and suggestions on providing further guidance on the reasonable basis standard. On November 12, 1996, proposed regulations [IA–42–95 (1996–49 I.R.B. 21) (see §601.601(d)(2)(ii)(*b*) of this chapter)] defining reasonable basis and making conforming changes to the final regulations relating to the accuracy-related penalty were published in the **Federal Register** (61 F.R. 58020).

Written comments responding to the notice of proposed rulemaking were received. A public hearing was held on February 25, 1997. After consideration of all the comments, the proposed regulations under section 6662 relating to the definition of reasonable basis for purposes of the accuracy-related penalty are adopted as revised by this Treasury decision.

In addition, on August 5, 1997, the Taxpayer Relief Act (TRA) of 1997, Pub. L. 105–34 (111 Stat. 788), was enacted. The Act added a restriction regarding whether or not a corporation has a reasonable basis for its tax treatment of an item for purposes of reducing the amount of the substantial understatement penalty. This restriction has been incorporated into the final regulations.

Explanation of Provisions and Summary of Comments

These final regulations provide that a return position will have a reasonable basis for purposes of the accuracy-related penalties if it is reasonably based on one or more certain authorities. Also, if the return position does not satisfy the reasonable basis standard, a reasonable cause and good faith exception may still apply.

One commentator suggested that the substantial authority standard in §1.6662–4(d)(3)(ii) of existing regulations and the reasonable basis standard in §1.6662–3(b)(3) of the proposed regulations be expanded to include as authority a well-reasoned construction of the applicable regulatory provisions in addition to the statutory provisions. The substantial authority standard in §1.6662–4(d)(3)(ii) has not been expanded to reflect this comment. However, the definition of reasonable basis in §1.6662–3(b)(3) has been clarified to include an explicit cross-reference to the nature of the analysis discussion in §1.6662–4(d)(3)(ii) of the substantial authority regulations.

Several commentators suggested that the final regulations explain where the reasonable basis standard ranks in the hierarchy of return position standards. This suggestion was not adopted. The final regulations do not rank the standards formally because such a comparison would change the focus of the reasonable basis regulations from the taxpayer's obligation to determine his or her tax liability in accordance with the internal revenue laws to

the probability of the return position prevailing in litigation.

Several commentators supported the exclusion of a numerical qualification of the reasonable basis standard in the proposed regulations because they believed that such a qualification would encourage arbitrary and mechanical application of the standards and create bad precedent outside the scope of the reasonable basis standard. The final regulations do not include a numerical qualification.

One commentator requested that the final regulations refer specifically to Rev. Rul. 59–60 (1959–1 C.B. 237) (see §601.601(d)(2)(ii)(*b*) of this chapter), which provides guidance regarding the valuation of stock of closely held corporations for estate and gift tax purposes. The final regulations do not adopt this suggestion. It is not necessary to include a reference to a specific revenue ruling because §1.6662–4(d)(3)(iii) of the existing regulations already lists revenue rulings as an acceptable type of authority.

One commentator requested that the final regulations clarify the effect of the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103–66 (107 Stat. 312), and the reasonable cause and good faith exception under section 6664 on a taxpayer's access to prepayment litigation in Tax Court. The final regulations do not adopt this suggestion. It is not necessary to clarify that a taxpayer has access to prepayment litigation in Tax Court because under section 6665 the Tax Court has jurisdiction to redetermine additions to tax in the same manner as the underlying tax.

Pursuant to the Taxpayer Relief Act of 1997, Pub. L. 105–34 (111 Stat. 788), §1.6662–4(e)(3) has been added to the final regulations. That section provides that for purposes of reducing the amount of the substantial understatement penalty by making an adequate disclosure, a corporation will not be treated as having a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction entered into after August 5, 1997, if the treatment does not clearly reflect the income of the corporation.

The Chief Counsel for Advocacy of the Small Business Administration requested that the preamble to the regulations explain why the IRS has concluded that this regulation is not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Chief Counsel for Advocacy submits that the regulations tighten the definition of reasonable basis and, thus, impose a de facto recordkeeping requirement because they may require small businesses to keep and maintain records (such as the documents referred to in §1.6662–4(d)(3)(iii)) to support tax reporting decisions.

After carefully considering these comments, the IRS and Treasury have concluded that this regulation is not subject to the Regulatory Flexibility Act, 5 U.S.C. § 603 (1994). That section requires a regulatory flexibility analysis for an interpretative rule involving the internal revenue laws only to the extent the interpretative rule imposes a collection of information requirement on small entities. A collection of information requirement is defined in 5 U.S.C. § 601(7) (1994) to mean the obtaining, causing to be obtained, soliciting, or requiring the disclosure to third parties or the public, of facts or opinions by or for an agency, regardless of form or format, calling for either (i) answers to identical questions posed to, or identical reporting or recordkeeping requirements imposed on, ten or more persons, other than agencies, instrumentalities, or employees of the United States, or (ii) answers to questions posed to agencies, instrumentalities, or employees of the United States that are to be used for general statistical purposes.

Furthermore, the phrase, recordkeeping requirement, is defined in 5 U.S.C. 601(8) (1994) as a requirement imposed by an agency on persons to maintain specified records. Ever since this term was first used in the Paperwork Reduction Act of 1980 (44 U.S.C. chapter 35), the IRS and Treasury have consistently interpreted the phrase as applying only when Treasury regulations directly require persons to maintain specified records. We believe this interpretation is consistent with the explicit statutory language as well as Congressional intent to apply the law only to situations in which government agencies require persons to maintain particular records.

Thus, we believe the final regulations do not impose a recordkeeping requirement or other collection of information requirement, as defined in 5 U.S.C. §§ 601(7), (8) (1994). The regulations do not impose on taxpayers additional requirements to either report information to the IRS or to keep specified records. Because the regulations do not contain a reporting requirement or other collection of information requirement, the provisions of the Regulatory Flexibility Act do not apply.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the proposed regulations on small business. The Chief Counsel for Advocacy submitted comments on these regulations, which are discussed above.

Drafting Information

The principal author of these regulations is Beverly A. Baughman, Office of the Assistant Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6662–0 is amended by:

1. Adding the entry for §1.6662–2(d)(4).

2. Removing the entries for §1.6662–3(b)(3)(i) and (ii).

3. Adding the entry for §1.6662–4(e)(3).

4. Revising the entry for §1.6662–7(d).

5. Removing the entries for §1.6662–7(d)(1) and (2).

The revision and additions read as follows:

§1.6662–0 Table of contents.

* * * * *

§1.6662–2 Accuracy-related penalty.

* * * * *

(d) * * *

(4) Special rule for reasonable basis.

* * * * *

§1.6662–4 Substantial understatement of income tax.

* * * * *

(e) * * *

(3) Restriction for corporations.

* * * * *

§1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

* * * * *

(d) Reasonable basis.

Par 3. Section 1.6662–2 is amended by:

1. Revising the second sentence in paragraph (d)(1).

2. Revising the first sentence in paragraph (d)(2).

3. Adding paragraph (d)(4).

The addition and revisions read as follows:

§1.6662–2 Accuracy-related penalty.

* * * * *

(d) * * * (1) * * * Except as provided in the preceding sentence and in paragraphs (d)(2), (3), and (4) of this section, §§1.6662–1 through 1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989, but before January 1, 1994. * * *

(2) *Returns due after December 31, 1993.* Except as provided in paragraphs (d)(3) and (4) of this section and the last sentence of this paragraph (d)(2), the provisions of §§1.6662–1 through 1.6662–4 and §1.6662–7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1993. * * *

* * * * *

(4) *Special rules for reasonable basis.* Section 1.6662–3(b)(3) applies to returns filed on or after December 2, 1998.

Par. 4. Section §1.6662–3 is amended by:

1. Revising the third sentence in paragraph (b)(1) introductory text.

2. Revising paragraph (b)(3).

The revisions read as follows:

§1.6662–3 Negligence or disregard of rules or regulations.

* * * * *

(b)* * * (1) * * * A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence. * * *

* * * * *

(3) *Reasonable basis.* Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in §1.6662–4(d)(2). (See §1.6662–4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in §1.6664–4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

* * * * *

Par. 5. Section 1.6662–4 is amended by:

1. Revising the second sentence in paragraph (d)(2).

2. Adding paragraph (e)(3).

The addition and revision reads as follows:

§1.6662–4 Substantial understatement of income tax.

* * * * *

(d) * * * (1) * * *

(2) * * * The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in §1.6662-3(b)(3). * * *

* * * * *

(e) * * * (1) * * *

(3) *Restriction for corporations.* For purposes of paragraph (e)(2)(i) of this section, a corporation will not be treated as having a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction entered into after August 5, 1997, if the treatment does not clearly reflect the income of the corporation.

* * * * *

Par. 6. In §1.6662–7, paragraph (d) is revised to read as follows:

§1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

* * * * *

(d) *Reasonable basis.* For purposes of §§1.6662–3(c) and 1.6662–4(e) and (f) (relating to methods of making adequate disclosure), the provisions of §1.6662–3(b)(3) apply in determining whether a return position has a reasonable basis.

Par. 7. Section 1.6664–0 is amended by:

1. Revising the entry for §1.6664–4(c)(2).

2. Removing the entries for §§1.6664–4(c)(1)(iii), (c)(2)(i), and (c)(2)(ii).

3. Adding the entry for §1.6664–4(g)(3).

The revision and addition reads as follows:

§1.6664-0 Table of contents.

* * * * *

§1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

(c) * * *

(2) Advice defined.

* * * * *

(g) * * *

(3) Special rules.

* * * * *

Par. 8. In §1.6664–4, paragraph (g) is revised to read as follows:

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

(g) *Valuation misstatements of charitable deduction property*—(1) *In general.* There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property (as defined in paragraph (g)(2) of this section) only if—

(i) The claimed value of the property was based on a qualified appraisal (as defined in paragraph (g)(2) of this section) by a qualified appraiser (as defined in paragraph (g)(2) of this section); and

(ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(2) *Definitions.* For purposes of this paragraph (g):

Charitable deduction property means any property (other than money or publicly traded securities, as defined in §1.170A–13(c)(7)(xi)) contributed by the taxpayer in a contribution for which a deduction was claimed under section 170.

Qualified appraisal means a qualified appraisal as defined in §1.170A–13(c)(3).

Qualified appraiser means a qualified appraiser as defined in §1.170A–13(c)(5).

(3) *Special rules.* The rules of this paragraph (g) apply regardless of whether §1.170A–13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a qualified appraisal. The rules of this paragraph (g) apply in addition to the generally applicable rules concerning reasonable cause and good faith.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved November 17, 1998.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 1, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 2, 1998, 63 F.R. 66433)

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 98–59

SECTION 1. PURPOSE

This revenue procedure (1) provides guidance on obtaining opinion letters to drafters of Roth IRAs and (2) provides transitional relief for users of Roth IRAs that have not been approved by the Internal Revenue Service.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Internal Revenue Code § 408A, added by § 302 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, permits the establishment of a new type of individual retirement arrangement, a Roth IRA, that taxpayers can use, beginning in 1998, to save money for their retirement or their beneficiaries. Except as otherwise provided in § 408A and the regulations thereunder, a Roth IRA is treated the same as a traditional IRA.

.02 Subsections (a) and (b) of § 408 set forth general requirements for individual retirement accounts and individual retirement annuities, respectively.

.03 Section 408(c) provides that a trust established by an employer or an association of employees for the benefit of employees or members, respectively, is treated as an IRA if there is a separate accounting for each employee or member and the trust otherwise satisfies the requirements of § 408(a) (a "section 408(c) IRA").

.04 In 1997, the Service issued two model forms, Form 5305–R and Form 5305–RA that may be used to establish a Roth IRA as a trust account or a custodial account, respectively. In 1998, the Service issued Form 5305–RB, a model endorsement that can be used to establish a Roth individual retirement annuity. Model forms issued by the Service contain preapproved language that, if followed, will satisfy the applicable statutory requirements. Model forms should not be submitted to the Service, even if additional provisions are added to Article IX of the forms, provided that the additional provisions comply with the instructions for Article IX. (But see section 3.05 of this revenue procedure regarding automatic approval of Roth IRA documents that contain language identical to a model form.)

.05 Announcement 97–122, 1997–50 I.R.B. 63 (December 15, 1997), which was issued at the same time as Forms 5305–R and 5305–RA, announced the issuance of these forms and provided interim guidance on Roth IRAs.

.06 On September 3, 1998, proposed Income Tax Regulations under § 408A were published in the Federal Register (63 F.R. 46937).

.07 Notice 98–49, 1998–38 I.R.B. 5 (September 21, 1998), provides guidance on Service-approved Roth IRA documents and IRA reporting requirements.

.08 Notice 98–50, 1998–44 I.R.B. 10 (November 2, 1998), provides guidance on reconverting amounts from a traditional IRA to a Roth IRA.

.09 Rev. Proc. 87–50, 1987–2 C.B. 647, provides the procedures for a sponsoring organization or a mass submitter (a "prototype sponsor") to apply to the Service for an opinion letter on whether a prototype traditional IRA meets the requirements of § 408(a) or (b). Rev. Proc. 87–50 also contains procedures for employers and employee associations to apply for a ruling on a section 408(c) IRA.

.10 Rev. Proc. 98–8, 1998–1 I.R.B. 225 (January 5, 1998), provides guidance to taxpayers for complying with the user-fee program as it pertains to matters under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations).

SECTION 3. OPINION LETTERS FOR ROTH IRAS

.01 *Prototype program.* A prototype sponsor may apply to the Service for an opinion letter for a Roth IRA submitted pursuant to this section 3. The same procedures and user fees apply to a submission for an opinion letter for a Roth IRA as those that apply for a traditional IRA, with the exceptions described in sections 3.02 and 3.03 below. (See Rev. Procs. 87–50 and 98–8.)

.02 *Procedural requirements.* An application for approval of a prototype Roth IRA must be submitted using Form 5306, Application for Approval of a Prototype Individual Retirement Arrangement, with the words "Roth IRA" written in the upper margin of the form. The application must be accompanied by a user fee in the same amount as set by Rev. Proc. 98-8 for a traditional IRA.

.03 *Dual-purpose prototype documents.* A prototype document can only be used as one type of IRA (traditional, SIMPLE, or Roth). However, a prototype document may be designed for use as either a traditional IRA or a Roth IRA provided the conditions in (1) and (2) below are satisfied:

(1) The document is designed so that, upon execution, the owner must explicitly and unambiguously indicate whether the IRA is to be a Roth IRA or a traditional IRA, and it is clear that designation as one type precludes its use as the other type.

(2) Contributions to a Roth IRA are maintained in a separate trust, custodial account or annuity from contributions to a traditional IRA.

Application for approval of such a dual-purpose prototype document must be submitted using Form 5306, with the words "Dual-purpose IRA" written in the upper margin of the form. Except in the case of a sponsoring organization's word-for-word identical adoption of a mass submitter's prototype dual-purpose IRA, the application must be accompanied by a user fee in the amount of 200 percent of the applicable fee set by Rev. Proc. 98-8 for a prototype IRA.

.04 *Section 408(c) IRA program.* An employer or employee association may apply to the Service for an opinion letter for a section 408(c) IRA that is a Roth IRA using the same procedures in sections 3.01 and 3.02 above that apply for a prototype Roth IRA.

.05 *Model form language.* The Service will not issue an opinion letter on a document which terms are word-for-word identical to the operative provisions of one of the model forms described in section 2.04 of this revenue procedure (other than any provisions which may be added as Article IX to the form). Such a document is deemed to meet the statutory requirements for a Roth IRA. However, the

document should indicate which model form it is identical to and the revision date of the form.

.06 *Sample language*. Sample language (also known as Listing of Required Modifications, or LRMs) that the Service finds acceptable for Roth IRAs may be obtained by writing to the Service at: Internal Revenue Service, 1111 Constitution Avenue NW, Attention OP:E:EP, Room 6550, Washington, D.C. 20224. "LRM Request" should be clearly printed on the envelope. Alternatively, a request for an LRM may be faxed to Nancy Arrington at (202) 622-6199.

SECTION 4. TRANSITIONAL RELIEF

.01 *Prototype IRAs*. An individual who establishes a trust, custodial account or annuity contract as a Roth IRA after December 31, 1997, and before the applicable date in section 4.01(3) below using a document that has not been approved by the Service for use as a Roth IRA is deemed to have used a document that has been approved by the Service for this use provided the conditions in sections 4.01(1) through 4.01(4) below are satisfied:

(1) The individual used a document provided by a prototype sponsor and the document, or associated written material, clearly designated the trust, custodial account or annuity as a Roth IRA at the time of establishment.

(2) On or before June 30, 1999, the prototype sponsor applies to the Service for an opinion letter on the document described in section 4.01(1) above using the procedures described in section 3 of this revenue procedure.

(3) The individual adopts the approved document within 120 days after the later of: (a) the date the Service issues a favorable opinion letter on the document to the prototype sponsor and (b) if the prototype sponsor seeks approval of the document from one or more state insurance departments not later than 90 days after the Service issues a favorable opinion letter on the document, the date the document is approved by all such state insurance departments. If, as a result of amendments to the document required by a state insurance department, the prototype sponsor applies to the Service for an opinion letter on the amended document within 90 days after it is approved by such state insurance department, the date in (a) in the preceding sentence is the date the Service issues a favorable opinion letter on the amended document.

(4) For the period beginning with the establishment of the Roth IRA and ending on the date the Service-approved document is adopted, the individual and the trustee, custodian or issuer comply in operation with § 408A.

.02 *Section 408(c) IRAs.* An employer or employee association that establishes a trust or custodial account under § 408(c) for use as a Roth IRA after December 31, 1997, and before June 30, 1999, using a document that has not been approved by the Service for use as a Roth IRA is deemed to have used a document that has been approved by the Service for this use provided the conditions in sections 4.02(1) through 4.02(4) below are satisfied.

(1) The employer or employee association used a document that clearly designated the trust or custodial account as a Roth IRA at the time of establishment.

(2) On or before June 30, 1999, the employer or employee association applies to the Service for an opinion letter on the document described in section 4.02(1) above using the procedures described in section 3 of this revenue procedure.

(3) The employer or employee association adopts the approved document within 30 days after the date the Service issues a favorable opinion letter on the document to the employer or employee association.

(4) For the period beginning with the establishment of the Roth IRA and ending on the date the Service-approved document is adopted, the employer or employee association, the employee for whose benefit the Roth IRA is established, and the trustee or custodian comply in operation with § 408A.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Section 6.06 of Rev. Proc. 98–8 is modified by sections 3.02 and 3.03 of this revenue procedure, and section 6.02 of Rev. Proc. 87–50 is modified by section 3 of this revenue procedure.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective on November 30, 1998.

DRAFTING INFORMATION

The principal author of this revenue procedure is Roger Kuehnle of the Employee Plans Division. For further information regarding this revenue procedure, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074/75 (not toll-free numbers) between 1:30 and 3:30 p.m., Eastern Time, Monday through Thursday.

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Credit for Increasing Research Activities

REG–105170–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the computation of the credit under section 41(c) and the definition of *qualified research* under section 41(d). The proposed regulations reflect changes to section 41 made by the Tax Reform Act of 1986, the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, and the Taxpayer Relief Act of 1997. The proposed regulations also provide certain technical amendments to the regulations.

DATES: Written comments must be received no later than March 2, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105170–97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–105170–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Lisa J. Shuman or Leslie H. Finlow at (202)622-3120 (not a toll-free number); concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, La Nita Van Dyke at (202)622-7190 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 2, 1999. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §§1.41–4(a) and 1.41–8(b). The information is required by the IRS to ensure that taxpayers have engaged in qualified research and to ensure the proper computation of the credit for increasing research activities under section 41. Section 1.41–4(a) defines a process of experimentation, as required for credit eligibility, to include the recording of the results of the experiments. This requirement imposes no additional recordkeeping burden, because taxpayers engaging in a bona fide process of experimentation already record the results in any event (see discussion under **Explanation of Provisions,** 3. *Documentation,* in this preamble). The information required by §1.41–8 will be used to determine if the taxpayer has elected or revoked the election to use the alternative incremental credit allowed under section 41(c)(4). The collection of information is mandatory. The likely respondents are businesses or other for-profit institutions and organizations. Responses to this collection of information are required to elect to use and to revoke the election to use the alternative incremental credit computation allowed under section 41(c)(4).

The reporting burden contained in §1.41–8(b)(2) (relating to the election of the alternative incremental credit) is reflected in the burden of Form 6765.

Estimated total annual reporting burden under §1.41–8(b)(3) (relating to the revocation of the election to use the alternative incremental credit): 250 hours.

Estimated average annual burden hours per respondent: 50 hours.

Estimated number of respondents: 5.

Estimated frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

The research credit provisions originally appeared in section 44F of the Internal Revenue Code of 1954 (the 1954 Code), as added to the 1954 Code by section 221 of the Economic Recovery Tax Act of 1981. Section 471(c) of the Tax Reform Act of 1984 redesignated section 44F as section 30. Section 231 of the Tax Reform Act of 1986 (the 1986 Act) redesignated section 30 as section 41 and substantially modified the research credit

provisions. The amendments made to section 41 by the 1986 Act primarily relate to the definition of *qualified research* in section 41(d) and the computation of *basic research* payments under section 41(e). The Revenue Reconciliation Act of 1989 (the 1989 Act), the Revenue Reconciliation Act of 1993 (the 1993 Act), the Small Business Job Protection Act of 1996 (the 1996 Act), and the Taxpayer Relief Act of 1997 (the 1997 Act) also amended the research credit provisions. These amendments primarily relate to the trade or business requirement in section 41(b) and the computation of the credit under sections 41(c) and 41(f).

On May 17, 1989, the IRS published in the **Federal Register** (54 F.R. 21203) final regulations under section 41. The 1989 final regulations generally do not reflect the amendments to section 41 made by the 1986 Act, the 1989 Act, the 1993 Act, the 1996 Act, and the 1997 Act. The amendments proposed by this document contain rules relating primarily to the amendments to section 41(d) made by the 1986 Act. The amendments proposed by this document also contain some rules relating to amendments to section 41 made by the 1989 Act, the 1996 Act, and the 1997 Act.

On January 2, 1997, the IRS published in the **Federal Register** (62 F.R. 81) proposed regulations (the 1997 proposed regulations) under section 41 describing when computer software that is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use can qualify for the credit for increasing research activities. The 1997 proposed regulations reflect a change to section 41 made by the 1986 Act. The proposed regulations set forth in this notice of proposed rulemaking complement but otherwise do not affect the 1997 proposed regulations.

The Tax and Trade Relief Extension Act of 1998 extended the research credit from June 30, 1998 through June 30, 1999. In the Conference Report, H.R. Rep. No. 105–825, at 1547–49 (1998), the conferees address the scope of the term *qualified research*, comment on an aspect of the process of experimentation requirement, and note a lack of clarity in the interpretation of the distinction between internal-use software and other software. These proposed regulations reflect the views expressed by the conferees, as well as prior legislative history, regarding the term *qualified research* and the process of experimentation. The IRS and Treasury request comments on the distinction between internal-use software and other software.

Explanation of Provisions

1. *Qualified Research*

Congress enacted the research credit to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. H.R. Rep. No. 99-426, at 177 (1985); S. Rep. No. 99–313, at 694 (1986). In extending the research credit in the 1986 Act, Congress expressed concern that, in practice, taxpayers had applied the existing definition of *qualified research* too broadly and some taxpayers had claimed the credit for virtually any expense relating to product development. H.R. Rep. No. 99–426, at 178; S. Rep. No. 99–313, at 694–95. Many taxpayers claiming the credit were not in industries that involved high technology or its application in developing technologically new and improved products or methods of production. H.R. Rep. No. 99–426, at 178; S. Rep. No. 99–313, at 695.

To address these concerns, Congress narrowed the scope of the research credit by providing in the Internal Revenue Code (Code) an express definition of the term *qualified research.* In determining eligibility for the research credit, section 41(d) requires that qualified research activities satisfy a multi-part test. First, the taxpayer's expenditures must be eligible to be treated as expenses under section 174. See §1.174–2(a)(1) (defining *research and experimental expenditures*).

Second, the expenditures must relate to research undertaken for the purpose of discovering information that is both technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer. The proposed regulations provide that research is undertaken for the purpose of discovering information that is technological in nature only if the research activities are undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of technology or science and the process of experimentation utilized fundamentally relies on principles of physical or biological sciences, engineering, or computer science. Consistent with the requirement that the research activities be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of technology or science, the credit may be available where the technological advance sought by the taxpayer is evolutionary, and, in certain circumstances, where the taxpayer is not the first to achieve the same advance. Moreover, the credit is available regardless of whether the taxpayer succeeds or fails in achieving the desired advance.

Third, section 41(d) requires that substantially all of the activities of the research constitute elements of a *process of experimentation* that relates to a new or improved function, performance, reliability or quality. As noted in the previous paragraph, the process of experimentation utilized must fundamentally rely on principles of physical or biological sciences, engineering, or computer science.

In developing a process of experimentation rule applicable to all scientific disciplines, IRS personnel met with personnel from the National Science Foundation and the National Institute of Standards and Technology. The proposed regulation explains that a process of experimentation is a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset. This requires that the taxpayer (i) develop one or more hypotheses designed to achieve the intended result; (ii) design a scientific experiment (that, where appropriate to the particular field of research, is intended to be replicable with an established experimental control) to test and analyze those hypotheses (through, for example, modeling, simulation, or a systematic trial and error methodology); (iii) conduct the experiment and record the results; and (iv) refine or discard the hypotheses as part of a sequential design process to develop or improve the business component.

The proposed regulation does not require that the results of the experiments be recorded in any specific manner. The results of the experiments should be

recorded in a manner that is appropriate for the particular field of science in which the experiment is conducted and for the type of experimentation involved. In some fields, for example, experiments are recorded in lab books. When developing computer software, by contrast, the experiments might be recorded in comment lines contained in the source code.

In the 1986 Act, Congress also specified that expenditures incurred in certain research, research-related, or non-research activities are not eligible for the credit. The excluded activities are: post-production activities, adaptation, duplication, surveys and studies, research outside the United States, research in the social sciences, funded research, and research related to certain internal-use computer software.

Section 1.41–4 of this proposed regulation contains rules that clarify the definition of the term qualified research and other terms used in section 41(d). The proposed regulation also provides rules relating to activities for which the research credit is not allowed.

2. *Application of Tests*

In the legislative history to the 1986 Act, Congress stated that if the requirements of section 41(d) are not met for an entire product, the term *business component* means the most significant set of elements of that product for which all the requirements of section 41(d) are met. The legislative history provides that this "shrinking back" is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test.

Consistent with the legislative history, §1.41–4(b) of the proposed regulation explains that the "shrinking-back" concept is the method for applying the tests in section 41(d) to a business component.

3. *Documentation*

Taxpayers must (a) record the results of their scientific experiments (in a manner that is appropriate for the particular field of science in which the experiment is conducted and for the type of experiment involved) and (b) comply with the recordkeeping requirements of section 6001 and the regulations thereunder. The requirement that taxpayers record the results of their scientific experiments is not intended to cause taxpayers to create records that otherwise would not be created. Rather, the recording of results is inherent in a process of experimentation to discover information that is technological in nature. Limiting the availability of the credit to taxpayers who record the results of their scientific experiments is not intended to change taxpayer behavior, but to identify taxpayers who engage in a bona fide process of experimentation and thus may be eligible for the credit.

4. *Election of the Alternative Incremental Credit*

The notice of proposed rulemaking provides rules for electing the alternative incremental credit, which may be elected under section 41(c)(4). Section 1.41-8 of the proposed regulation provides that the election is made on Form 6765, "Credit for Increasing Research Activities," and that the completed form must be attached to the taxpayer's timely filed original return (including extensions) for the taxable year to which the election applies.

Proposed Effective Date

In general, the regulations are proposed to be effective for expenditures paid or incurred on or after the date final regulations are published in the **Federal Register.** The regulations addressing the base amount are proposed to be effective for taxable years beginning on or after the date final regulations are published in the **Federal Register.** The regulations providing for the election and revocation of the alternative incremental credit are proposed to be effective for taxable years ending on or after the date final regulations are published in the **Federal Register.** No inference should be drawn from the proposed effective date concerning the application of section 41 to expenditures paid or incurred or the computation of the base amount before the proposed effective date.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. This certification is based on the information that follows. The economic impact of the collection of information contained in these regulations on any small entity would result from the entity being required to (1) record the results of experiments related to its qualified research activities, (2) elect on Form 6765 to use the alternative incremental credit if the entity desires to use that method, and (3) obtain permission to revoke the alternative incremental credit election, if so desired. Because taxpayers record results in conducting their research activities in any event (see discussion under **Explanation of Provisions,** 3. *Documentation,* in this preamble), the economic impact of the recordkeeping requirement in the regulation would not be significant. The economic impact of electing the alternative incremental credit on Form 6765 also would not be significant because the election is made on the same form and is based on the same information that is used to claim the research credit. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. Submissions might include comments on the definition of gross receipts, comments regarding the exclusion for post-production activities, comments on whether and how the definition of a process of experimentation should be refined to ensure that it is appropriate for all scientific fields, and comments on the interaction of the discovery requirement and the duplication exclusion and the effect of such interaction on specific industries. Also, submissions

might include comments on clarifying the distinction between internal-use software (i.e., software described in section 41(d)(4)(E)) and other software. All comments will be available for public inspection and copying.

A public hearing will be scheduled in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The IRS recognizes that persons outside the Washington, DC area also may wish to testify at the public hearing through teleconferencing. Requests to include teleconferencing sites must be received by January 18, 1999. If the IRS receives sufficient indications of interest to warrant teleconferencing to a particular city, and if the IRS has teleconferencing facilities available in that city on the date the public hearing is to be scheduled, the IRS will try to accommodate the requests.

The IRS will publish the time and date of the public hearing and the locations of any teleconferencing sites in an announcement in the **Federal Register.** The announcement will include the date by which persons that wish to present oral comments at the hearing must submit requests to speak, outlines of the topics to be discussed, and the time to be devoted to each topic.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Lisa J. Shuman and Leslie H. Finlow of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows. (Note: The proposed amendments complement the proposed amendments published at 62 F.R. 83, January 2, 1997.)

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Revise the undesignated centerheading immediately before §1.30–1 to read as follows:

CREDITS ALLOWABLE UNDER SECTION 30 THROUGH 44B

Par. 3. Remove the undesignated centerheading immediately before §1.41–0.

Par. 4. Section 1.41–0 is revised to read as follows:

§1.41–0 Table of contents.

This section lists the paragraphs contained in §§1.41–0 through 1.41–8.

§1.41–0 Table of contents.

§1.41–1 Credit for increasing research activities.

(a) Basic principles.
(b) Amount of credit.
(c) Introduction to regulations under section 41.

§1.41–2 Qualified research expenses.

(a) Trade or business requirements.
(1) In general.
(2) New business.
(3) Research performed for others.
(i) Taxpayer not entitled to results.
(ii) Taxpayer entitled to results.
(4) Partnerships.
(i) In general.
(ii) Special rule for certain partnerships and joint ventures.
(b) Supplies and personal property used in the conduct of qualified research.
(1) In general.
(2) Certain utility charges.
(i) In general.
(ii) Extraordinary expenditures.
(3) Right to use personal property.
(4) Use of personal property in taxable years beginning after December 31, 1985.
(c) Qualified services.
(1) Engaging in qualified research.
(2) Direct supervision.
(3) Direct support.
(d) Wages paid for qualified services.
(1) In general.
(2) "Substantially all."
(e) Contract research expenses.
(1) In general.
(2) Performance of qualified research.
(3) "On behalf of."
(4) Prepaid amounts.
(5) Examples.

*§1.41–3 Base amount for taxable years beginning on or after the date final regulations are published in the **Federal Register.***

(a) and (b) [Reserved]
(c) Definition of gross receipts.
(1) In general.
(2) Amounts excluded.
(3) Foreign corporations.
(d) Consistency requirement.
(1) In general.
(2) Illustrations.

*§1.41–4 Qualified research for expenditures paid or incurred on or after the date final regulations are published in the **Federal Register.***

(a) Qualified research.
(1) General rule.
(2) Requirements of section 41(d)(1).
(3) Discovering information.
(4) Technological in nature.
(5) Process of experimentation.
(6) Substantially all requirement.
(7) Use of computers and information technology.
(8) Illustrations.
(b) Application of requirements for qualified research.
(1) In general.
(2) Shrinking-back rule.
(3) Illustration.
(c) Excluded activities.
(1) In general.
(2) Research after commercial production.
(i) In general.
(ii) Certain additional activities related to the business component.
(iii) Activities related to production process or technique.
(3) Adaptation of existing business components.
(4) Duplication of existing business component.
(5) Surveys, studies, research relating to management functions, etc.
(6) Internal-use computer software.
(7) Activities outside the United States.
(i) In general.
(ii) Apportionment of in-house research expenses.
(iii) Apportionment of contract research expenses.
(8) Research in the social sciences, etc.
(9) Research funded by any grant, contract, or otherwise.
(10) Illustrations.

(d) Documentation.

§1.41–5 Basic research for taxable years beginning after December 31, 1986.
[Reserved]

§1.41–6 Aggregation of expenditures.

(a) Controlled group of corporations; trades or businesses under common control.
(1) In general.
(2) Definition of trade or business.
(3) Determination of common control.
(4) Examples.
(b) Minimum base period research expenses.
(c) Tax accounting periods used.
(1) In general.
(2) Special rule where timing of research is manipulated.
(d) Membership during taxable year in more than one group.
(e) Intra-group transactions.
(1) In general.
(2) In-house research expenses.
(3) Contract research expenses.
(4) Lease payments.
(5) Payment for supplies.

§1.41–7 Special rules.

(a) Allocations.
(1) Corporation making an election under subchapter S.
(i) Pass-through for taxable years beginning after December 31, 1982, in the case of an S corporation.
(ii) Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.
(2) Pass-through in the case of an estate or trust.
(3) Pass-through in the case of a partnership.
(i) In general.
(ii) Certain expenditures by joint ventures.
(4) Year in which taken into account.
(5) Credit allowed subject to limitation.
(b) Adjustments for certain acquisitions and dispositions—Meaning of terms.
(c) Special rule for pass-through of credit.
(d) Carryback and carryover of unused credits.

§1.41–8 Special rules for taxable years ending on or after the date final regulations are published in the ***Federal Register.***

(a) Alternative incremental credit.
(b) Election.
(1) In general.
(2) Time and manner.
(3) Revocation.

Par. 5. Section 1.41–1 is revised to read as follows:

§1.41–1 Credit for increasing research activities.

(a) *Basic principles.* Section 41 provides a credit for increasing research activities. The credit is intended to encourage business firms to perform the technological research necessary to increase the innovative qualities and efficiency of the U.S. economy. The credit provides an incentive for business firms to increase their expenditures for research to obtain new knowledge through a scientific process of experimentation. Consequently, the credit is not to be applied too broadly or in a manner such that virtually any expense relating to the development of a product is eligible for the credit, even if some portion of the expense of developing the product does qualify for the credit. Similarly, the credit is not available for an expenditure merely because the expenditure may be treated as an expense under section 174. On the other hand, the credit may be available even though the technological advance sought by the taxpayer is evolutionary, and, in certain circumstances, even if another taxpayer has previously achieved the same advance. Moreover, the credit is available regardless of whether the taxpayer succeeds or fails in achieving the desired advance. The credit is limited to eligible expenditures paid or incurred for qualified research, as defined in section 41(d) and §1.41–4.

(b) *Amount of credit.* The amount of a taxpayer's credit is determined under section 41(a). For taxable years beginning after June 30, 1996, and at the election of the taxpayer, the portion of the credit determined under section 41(a)(1) may be calculated using the alternative incremental credit set forth in section 41(c)(4).

(c) *Introduction to regulations under section 41.* (1) Sections 1.41–2 through 1.41–8 and 1.41–3A through 1.41–5A address only certain provisions of section 41. The following table identifies the provisions of section 41 that are addressed, and lists each provision with the section of the regulations in which it is covered.

Section of the regulation	Section of the Internal Revenue Code
§1.41–2	41(b)
§1.41–3	41(c)
§1.41–4	41(d)
§1.41–5	41(e)
§1.41–6	41(f)
§1.41–7	41(f) 41(g)
§1.41–8	41(c)

Section of the regulation	Section of the Internal Revenue Code
§1.41–3A	41(c) (taxable years beginning before January 1, 1990)
§1.41–4A	41(d) (taxable years beginning before January 1, 1986)
§1.41–5A	41(e) (taxable years beginning before January 1, 1987)

(2) Section 1.41–3A also addresses the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated sections 30 and 44F. Sections 1.41–0 through 1.41–8 and 1.41–0A through 1.41–5A refer to these sections as section 41 for conformity purposes. Whether section 41, former section 30, or former section 44F applies to a particular expenditure depends upon when the expenditure was paid or incurred.

§1.41–2 [Amended]

Par. 6. Section 1.41–2 is amended as follows:

1. The last sentence of paragraph (a)(3)(i) is amended by removing the language "§1.41–5(d)(2)" and adding "§1.41–4A(d)(2)" in its place.

2. The last sentence of paragraph (a)(3)(ii) is amended by removing the language "§1.41–5(d)(3)" and adding "§1.41–4A(d)(3)" in its place.

3. The last sentence of paragraph (a)(4)(ii)(F) is amended by removing the language "§1.41–9(a)(3)(ii)" and adding "§1.41–7(a)(3)(ii)" in its place.

4. Paragraph (e)(1)(i) is amended by removing the language "§1.41–5" and adding "§1.41–4 or 1.41–4A, whichever is applicable" in its place.

Par. 7. An undesignated centerheading is added immediately following §1.44B–1 to read as follows:

RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990

§1.41–3 [Redesignated as §1.41–3A]

Par. 8. Section 1.41–3 is redesignated as §1.41–3A and added under the new undesignated centerheading "RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990."

Par. 9. New §1.41-3 is added to read as follows:

§1.41–3 Base amount for taxable years beginning on or after the date final regulations are published in the ***Federal Register.***

(a) and (b) [Reserved]

(c) *Definition of gross receipts*—(1) *In general.* For purposes of section 41, gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(2) *Amounts excluded.* For purposes of this paragraph (c), gross receipts do not include amounts representing—

(i) Returns or allowances;

(ii) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(iii) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(iv) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2); and

(v) Amounts received with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority.

(3) *Foreign corporations.* For purposes of section 41, in the case of a foreign corporation, gross receipts include only gross receipts that are effectively connected with the conduct of a trade or business within the United States. See section 864(c) and applicable regulations thereunder for the definition of effectively connected income.

(d) *Consistency requirement*—(1) *In general.* In computing the credit for increasing research activities for taxable years beginning after December 31, 1989, qualified research expenses and gross receipts taken into account in computing a taxpayer's fixed-base percentage and a taxpayer's base amount must be determined on a basis consistent with the definition of qualified research expenses and gross receipts for the credit year, without regard to the law in effect for the taxable years taken into account in computing the fixed-base percentage or the base amount. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any taxable year taken into account in computing the fixed-base percentage or the base amount.

(2) *Illustrations.* The following examples illustrate the application of the consistency rule of paragraph (d)(1) of this section:

Example 1. (i) X, an accrual method taxpayer using the calendar year as its taxable year, incurs qualified research expenses in 1990. X wants to compute its research credit under section 41 for the tax year ending December 31, 1990. As part of the computation, X must determine its fixed-base percentage, which depends in part on X's qualified research expenses incurred during the fixed-base period, the taxable years beginning after December 31, 1983, and before January 1, 1989.

(ii) During the fixed-base period, X reported the following amounts as qualified research expenses on its Form 6765:

1984	$ 100x
1985	120x
1986	150x
1987	180x
1988	170x
Total	$ 720x

(iii) For the taxable years ending December 31, 1984, and December 31, 1985, X based the amounts reported as qualified research expenses on the definition of qualified research in effect for those taxable years. The definition of qualified research changed for taxable years beginning after December 31, 1985. If X used the definition of qualified research applicable to its taxable year ending December 31, 1990, the credit year, its qualified research expenses for the taxable years ending December 31, 1984, and December 31, 1985, would be reduced to $ 80x and $ 100x, respectively. Under the consistency rule in section 41(c)(5) and paragraph (d)(1) of this section, to compute the research credit for the tax year ending December 31, 1990, X must reduce its qualified research expenses for 1984 and 1985 to reflect the change in the definition of qualified research for taxable years beginning after December 31, 1985. Thus, X's total qualified research expenses for the fixed-base period (1984-1988) to be used in computing the fixed-base percentage is $ 80 + 100 + 150 + 180 + 170 = $ 680x.

Example 2. The facts are the same as in *Example 1*, except that, in computing its qualified research expenses for the taxable year ending December 31, 1999, X claimed that a certain type of expenditure incurred in 1999 was a qualified research expense. X's claim reflected a change in X's position, because X had not previously claimed that similar expenditures were qualified research expenses. The consistency rule requires X to adjust its qualified research expenses in computing the fixed-base percentage to include any similar expenditures not treated as qualified research expenses during the fixed-base period, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.

Par. 10. Section 1.41–4 is revised to read as follows:

§1.41–4 Qualified research for expenditures paid or incurred on or after the date final regulations are published in the ***Federal Register.***

(a) *Qualified research*—(1) *General rule.* Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet all of the requirements of section 41(d)(1) and this section, and are not otherwise excluded under section 41(d)(3)(B) or (4), or this section.

(2) *Requirements of section 41(d)(1).* Research constitutes qualified research only if it is research—

(i) With respect to which expenditures may be treated as expenses under section 174, see §1.174–2;

(ii) That is undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.

(3) *Discovering information.* For purposes of section 41(d) and this section, the term *discovering information* means obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of technology or science.

(4) *Technological in nature.* For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of physical or biological sciences, engineering, or computer science.

(5) *Process of experimentation.* For purposes of section 41(d) and this section, a process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset. A process of experimentation in the physical or biological sciences, engineering, or computer science requires that the taxpayer—

(i) Develop one or more hypotheses designed to achieve the intended result;

(ii) Design a scientific experiment (that, where appropriate to the particular field of research, is intended to be replicable with an established experimental control) to test and analyze those hypotheses (through, for example, modeling, simulation, or a systematic trial and error methodology);

(iii) Conduct the experiment and record the results; and

(iv) Refine or discard the hypotheses as part of a sequential design process to develop or improve the business component.

(6) *Substantially all requirement.* The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis, constitute elements of a process of experimentation for a purpose described in section 41(d)(3). The substantially all requirement is applied separately to each business component.

(7) *Use of computers and information technology.* The employment of computers or information technology, or the reliance on principles of computer science or information technology to store, collect, manipulate, translate, disseminate, produce, distribute, or process data or information, and similar uses of computers and information technology does not itself establish that qualified research has been undertaken.

(8) *Illustrations.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. (i) *Facts.* X undertakes to develop for sale a tool that would improve its suite of application development products. The desired tool would handle connectivity problems for software application developers by providing data access via a layer of software that is more effective than existing software at finding data in various locations and forms within a network, translating it if need be, and then delivering the result to whatever application or user requested it. The means of developing such versatile database access middleware are not in the common knowledge of skilled professionals in the relevant technological fields. In order to determine whether it can successfully develop the desired tool, X develops, tests, and discards or refines various algorithms and protocols.

(ii) *Conclusion.* X's activities to develop the technology to build the new software development tool may be qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section. In developing the technology, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 2. (i) *Facts.* X acquired a new software environment, including a new operating system and a new database management system with related tools. X undertook a project to redeploy its data processing systems to the new software environment. X anticipated that, relative to the old system, the new system would significantly increase the time-sharing capabilities of its computer system. The project activities included redesign of databases and user interfaces, and translation of code from one programming language to another. In migrating to the new software environment, X relied on techniques and approaches that were within the common knowledge of skilled professionals in the relevant technological fields.

(ii) *Conclusion.* X's activities to redeploy its data processing systems to the new software environment are not qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section. X did not undertake to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 3. (i) *Facts.* X operates a computer system that does not recognize dates beginning in

the year 2000. In order to ensure that its computer system will not malfunction in the year 2000, X incurs substantial costs having its employees manually search its computer programs to find all date fields used in the programs and replace all of the date fields with year 2000 compliant date fields.

(ii) *Conclusion.* Because the activities of X's employees were not undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields and do not involve a process of experimentation, the activities are not qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

Example 4. (i) *Facts.* X is engaged in the business of developing and manufacturing widgets. X wants to manufacture an improved widget made out of a material that X has not previously used. Although X is uncertain how to use the material to manufacture an improved widget, the viability and means of using the material to manufacture such widgets are within the common knowledge of skilled professionals in the relevant technological fields.

(ii) *Conclusion.* Even though X's expenditures for the activities to resolve the uncertainty in manufacturing the improved widget may be treated as expenses for research activities under section 174 and §1.174–2, X's activities to resolve the uncertainty in manufacturing the improved widget are not qualified research within the meaning of section 41(d) and paragraph (a) of this section. Although X's activities were intended to eliminate uncertainty, the activities were not undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 5. (i) *Facts.* X desires to build a bridge that can sustain greater traffic flow without deterioration than can existing bridges. The technology used to build such a bridge is not in the common knowledge of skilled professionals in the relevant technological fields. X eventually abandons the project after attempts to develop the technology prove unsuccessful.

(ii) *Conclusion.* X's activities to develop the technology to build the bridge may be qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section, regardless of the fact that X did not actually succeed in developing that technology. In seeking to develop the technology, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 6. (i) *Facts.* The facts are the same as in *Example 5*, except that Y successfully builds a bridge that can sustain the greater traffic flow. Thereafter, Z seeks to build a bridge that can also sustain such greater traffic flow. The technology used by Y to build its bridge is a closely guarded secret that is not known to Z and remains beyond the common knowledge of skilled professionals in the relevant technological fields.

(ii) *Conclusion.* Z's activities to develop the technology to build the bridge may be qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section, even if it so happens that the technology used by Z to build its bridge is similar or identical to the technology used by Y. In developing the technology, Z undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 7. (i) *Facts.* X and other manufacturing companies have previously designed and manufactured a particular kind of machine using Material S. Material T is less expensive than Material S. X wishes to design a new machine that appears and functions exactly the same as its existing machines, but that is made of Material T instead of Material S. The technology necessary to achieve this objective is not within the common knowledge of skilled professionals in the relevant technological fields.

(ii) *Conclusion.* X's activities to design the new machine using Material T may be qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section. In seeking to design the machine, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

Example 8. (i) *Facts.* X, a tire manufacturer, seeks to build a tire that will not deteriorate as rapidly under certain conditions of high speed and temperature as do existing tires. The design of such a tire is not within the common knowledge of skilled professionals in the relevant technological fields. X commences laboratory research on January 1. On April 1, X determines in the laboratory that a certain combination of materials and additives can withstand higher rotational speeds and temperatures than the combination of materials and additives used in existing tires. On the basis of this determination, X undertakes further research activities to determine how to design a tire using those materials and additives, and to determine whether such a tire functions outside the laboratory as intended under various actual road conditions. By September 1, but not prior to September 1, X's research has progressed to the point where, applying X's knowledge to date, both the viability and means of producing the desired tire would be within the common knowledge of skilled professionals in the relevant technological fields. However, X continues to engage in certain research activities related to the tire after September 1, and until the first tire rolls off the assembly line on December 1.

(ii) *Conclusion.* Some or all of X's research activities until September 1 may be qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section. In seeking to design the tire, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields. The activities conducted after September 1 are not qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section, because those activities were not undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant technological fields.

(b) *Application of requirements for qualified research*—(1) *In general.* The requirements for qualified research in section 41(d)(1) and paragraph (a) of this section, must be applied separately to each business component, as defined in section 41(d)(2)(B). In cases involving development of both a product and a manufacturing or other commercial production process for the product, research activities relating to development of the process are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the process without taking into account the research activities relating to development of the product. Similarly, research activities relating to development of the product are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the product without taking into account the research activities relating to development of the manufacturing or other commercial production process.

(2) *Shrinking-back rule.* The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component to be held for sale, lease or license, or used by the taxpayer in a trade or business of the taxpayer. If all aspects of the requirements are not met at the first level, the requirements are to be applied at the next most significant subset of elements of the business component. The shrinking-back of the applicable business component continues until a subset of elements of the business component satisfies the requirements of section 41(d) and paragraph (a) of this section (treating that subset of elements as a business component) or the most basic element fails to satisfy the requirements.

(3) *Illustration.* The following example illustrates the application of this paragraph (b):

Example. X, a motorcycle engine builder, develops a new carburetor for use in a motorcycle engine. X also modifies an existing engine design for use with the new carburetor. Under the shrinking-back rule, the requirements of section 41(d)(1) and paragraph (a) of this section are applied first to the engine. If the modifications to the engine when viewed as a whole, including the development of the new carburetor, do not satisfy the requirements of section 41(d)(1) and paragraph (a) of this section, those requirements are applied to the next most significant subset of elements of the business component. For purposes of this example, it is assumed that the new carburetor is the next most significant subset of elements of the business component. The research activities in developing the new carburetor may constitute qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

(c) *Excluded activities*—(1) *In general.* Qualified research does not include any activity described in sections 41(d)(3)(B) and (4), this paragraph (c), and paragraph (e) of this section.

(2) *Research after commercial production*—(i) *In general.* Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) *Certain additional activities related to the business component.* The following activities are deemed to occur after the beginning of commercial production of a business component—

(A) Preproduction planning for a finished business component;

(B) Tooling-up for production;

(C) Trial production runs;

(D) Trouble shooting involving detecting faults in production equipment or processes;

(E) Accumulating data relating to production processes; and

(F) Debugging or correcting flaws in a business component.

(iii) *Activities related to production process or technique.* In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

(3) *Adaptation of existing business components.* Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

(4) *Duplication of existing business component.* Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer inspects an existing business component in the course of developing its own business component.

(5) *Surveys, studies, research relating to management functions, etc.* Qualified research does not include activities relating to—

(i) Efficiency surveys;

(ii) Management functions (except for the direct supervision of qualified research as defined in §1.41–2(c)(2)) or techniques, including such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line);

(iii) Market research, testing, or development (including advertising or promotions);

(iv) Routine data collections; or

(v) Routine or ordinary testing or inspections for quality control.

(6) *Internal-use computer software.* [Reserved].[1]

(7) *Activities outside the United States*—(i) *In general.* Research conducted outside the United States, as defined in section 7701(a)(9), does not constitute qualified research.

(ii) *Apportionment of in-house research expenses.* In-house research expenses paid or incurred for qualified services performed both in the United States and outside the United States must be apportioned between the services performed in the United States and the services performed outside the United States. Only those in-house research expenses apportioned to the services performed within the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of §1.41–2(d)(2) applies.

(iii) *Apportionment of contract research expenses.* If contract research is performed partly in the United States and partly outside the United States, only 65 percent (or 75 percent in the case of amounts paid to qualified research consortia) of the portion of the contract amount that is attributable to the research activity performed in the United States may qualify as a contract research expense (even if 80 percent or more of the contract amount is for research performed in the United States).

(8) *Research in the social sciences, etc.* Qualified research does not include research in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities.

(9) *Research funded by any grant, contract, or otherwise.* Qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). To determine the extent to which research is so funded, §1.41-4A(d) applies.

(10) *Illustrations.* The following examples illustrate provisions contained in paragraphs (c)(1) through (9) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts:

Example 1. (i) Facts. X, a pharmaceutical company, performs additional clinical tests on one of its products after that product has been approved for a specific therapeutic use by the FDA and is ready for commercial production and sale. The clinical tests study the drug's long-term morbidity and mortality profile, and are undertaken to develop information to use in the marketing materials for the drug.

(ii) *Conclusion.* Because the additional tests are performed after the drug is ready for commercial sale, X's activities in connection with the tests are excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section.

[1]Section 1.41–4(e), proposed on January 2, 1997 (62 F.R. 83), including any revisions to that proposed rule will be incorporated as this paragraph (c)(6) in the final rule.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that, while studying the long-term morbidity and mortality profile of the drug product, X discovers that the product may be useful in treating a different medical condition. X begins new clinical studies to establish the compound's new potential therapeutic use.

(ii) *Conclusion.* Because the new clinical studies are performed to establish a new therapeutic use of the drug product, the additional clinical studies performed to establish the new therapeutic use are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 3. (i) *Facts.* X, a domestic corporation that manufactures paper, develops and markets a new type of paper containing a different chemical composition than the paper generally available for commercial sale. Prior to manufacturing the paper, X conducts preproduction planning for the finished paper product, tools up for production, conducts trial production runs, engages in trouble shooting involving detecting problems in production equipment, accumulates production process data, and debugs the product.

(ii) *Conclusion.* X's activities of preproduction planning, tooling up for production, trial production runs, trouble shooting, accumulation of production process data, and product debugging do not constitute qualified research with respect to development of the paper product because the activities are deemed to occur after the beginning of commercial production of the product. Whether any activities engaged in by X to develop a process for manufacturing the paper constitute qualified research depends on whether the development of the process itself separately satisfies the requirements of section 41(d) and this section, and whether the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

Example 4. (i) *Facts.* X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. After entering into a contractual agreement with a customer, X incurs expenditures in modifying the core software program to adapt the program to the customer's requirement or need.

(ii) *Conclusion.* Because X's activities represent activities to modify an existing software program to adapt the program to a particular customer's requirement, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 5. (i) *Facts.* An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to discover potential alternative formulations of the additive (i.e., the development and use of various ingredients other than C to use with A and B).

(ii) *Conclusion.* X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to discover potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 6. (i) *Facts.* X, an appliance manufacturer, rearranges employee work stations in its manufacturing assembly line and develops a new employee training program to train employees for the rearranged work stations.

(ii) *Conclusion.* X's activities associated with rearranging the work stations and developing a new employee training program represent activities related to management functions or techniques and are excluded from qualified research under section 41(d)(4)(D) and paragraph (c)(5) of this section.

Example 7. (i) Facts. X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) *Conclusion.* X's activities related to the new product represent research in the social sciences, and are thus excluded from qualified research under section 41(d)(4)(G) and paragraph (c)(7) of this section.

(d) *Documentation.* See section 6001 and the regulations thereunder for the recordkeeping requirements that must be satisfied.

§1.41–5 [Redesignated as §1.41–4A, and Amended]

Par. 11. Section 1.41–5 is redesignated as §1.41–4A, and the last sentence of paragraph (d)(1) is amended by removing the language "§1.41–8(e)" and adding "§1.41–6(e)" in its place.

§1.41–6 [Redesignated as §1.41–5 and Amended]

Par. 12. Section 1.41–6 is redesignated as §1.41–5 and the section heading is amended by removing the language "December 31, 1985" and adding "December 31, 1986" in its place.

§1.41–7 [Redesignated as §1.41–5A, and Amended]

Par. 13. Section 1.41–7 is redesignated as §1.41–5A, and amended as follows:

1. The section heading is amended by removing the language "January 1, 1986" and adding "January 1, 1987" in its place.

2. Paragraph (e)(2) is amended by removing the language "§1.41–5(c)" and adding "1.41–4A(c)" in its place.

§1.41–8 [Redesignated as §1.41–6, and Amended]

Par. 14. Section 1.41–8 is redesignated as §1.41–6, and the last sentence of paragraph (c) is amended by removing the language "§1.41–3, except that §1.41–3(c)(2)" and adding "§1.41–3A, except that §1.41–3A(c)(2)" in its place.

§1.41–9 [Redesignated as §1.41–7]

Par. 15. Section 1.41–9 is redesignated as §1.41–7.

Par. 16. New §1.41–8 is added to read as follows:

§1.41–8 Special rules for taxable years ending on or after the date final regulations are published in the ***Federal Register.***

(a) *Alternative incremental credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(4).

(b) *Election*—(1) *In general.* A taxpayer may elect to apply the provisions of the alternative incremental credit in section 41(c)(4) for any taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer makes an election under section 41(c)(4), the election applies to the taxable year for which made and all subsequent taxable years.

(2) *Time and manner of election.* An election under section 41(c)(4) is made by completing the portion of Form 6765, "Credit for Increasing Research Activities," relating to the election of the alternative incremental credit, and attaching the completed form to the taxpayer's timely filed original return (including extensions) for the taxable year to which the election applies.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer must attach the Commissioner's consent to revoke an election under section 41(c)(4) to the taxpayer's timely filed original return (including extensions) for the taxable year of the revocation.

Par. 17. Section 1.41–0A is added under the new undesignated centerhead-

ing "RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990" to read as follows:

§1.41–0A Table of contents.

This section lists the paragraphs contained in §§1.41–0A, 1.41–3A, 1.41–4A and 1.41–5A.

§1.41–0A Table of contents.

§1.41–3A Base period research expenses.

(a) Number of years in base period.
(b) New taxpayers.
(c) Definition of base period research expenses.
(d) Special rules for short taxable years.
(1) Short determination year.
(2) Short base period year.
(3) Years overlapping the effective dates of section 41 (section 44F).
(i) Determination years.
(ii) Base period years.
(4) Number of months in a short taxable year.
(e) Examples.

§1.41–4A Qualified research for taxable years beginning before January 1, 1986.

(a) General rule.
(b) Activities outside the United States.
(1) In-house research.
(2) Contract research.
(c) Social sciences or humanities.
(d) Research funded by any grant, contract, or otherwise.
(1) In general.
(2) Research in which taxpayer retains no rights.
(3) Research in which the taxpayer retains substantial rights.
(i) In general.
(ii) Pro rata allocation.
(iii) Project-by-project determination.
(4) Independent research and development under the Federal Acquisition Regulations System and similar provisions.
(5) Funding determinable only in subsequent taxable year.
(6) Examples.

§1.41–5A Basic research for taxable years beginning before January 1, 1987.

(a) In general.
(b) Trade or business requirement.
(c) Prepaid amounts.
(1) In general.
(2) Transfers of property.
(d) Written research agreement.
(1) In general.
(2) Agreement between a corporation and a qualified organization after June 30, 1983.
(i) In general.
(ii) Transfers of property.
(3) Agreement between a qualified fund and a qualified educational organization after June 30, 1983.
(e) Exclusions.
(1) Research conducted outside the United States.
(2) Research in the social sciences or humanities.
(f) Procedure for making an election to be treated as a qualified fund.

§1.218–0 [Removed]

Par. 18. Section 1.218–0 is removed.

§1.482–7 [Amended]

Par. 19. In §1.482–7, the sixth sentence of paragraph (h)(1) is amended by removing the language "§1.41–8(e)" and adding "§1.41–6(e)" in its place.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 1, 1998, 8:45 a.m., and published in the issue of the Federal Register for December 2, 1998, 63 F.R. 66503)

Classification of Certain Transactions Involving Computer Programs; Correction

Announcement 98–109

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to Treasury Decision 8785 (1998–42 I.R.B. 5), which was published in the **Federal Register** on Friday, October 2, 1998 (63 F.R. 52971) relating to the tax treatment of certain transactions involving the transfer of computer programs.

DATES: This correction is effective October 2, 1998.

FOR FURTHER INFORMATION CONTACT: Anne Shelburne, (202) 874-1305 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction are under section 861 of the Internal Revenue Code.

Need for Correction

As published, T.D. 8785 contains errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8785), which were the subject of F.R. Doc. 98–26475, is corrected as follows:

1. On page 52971, column 1, in the preamble under the caption heading "FOR FURTHER INFORMATION CONTACT", line 1, the language "Anne Shelburne, (202) 622-3880 (not a" is corrected to read "Anne Shelburne, (202) 874-1305 (not a".

2. On page 52975, column 3, in the preamble under the paragraph heading *"8. Services and Know-How"*, second paragraph, lines 21 through 25, the language "secret protection. Know-how is considered a property interest under applicable law, and only if the know-how is specifically contracted for between the parties. These additional" is corrected to read "secret protection. These additional".

§1.861–18 [Corrected]

3. On page 52982, column 1, §1.861–18(i)(4) *Example 1*, line three from the bottom of the paragraph, the language "A is not required to change from its accrual" is corrected to read "A is not required to change from its".

4. On page 52982, column 2, §1.861–18(i)(4) *Example 2*, line five from the bottom of the paragraph, the language "A is not required to change from its accrual" is corrected to read "A is not required to change from its".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

Substantiation of Business Expenses—Use of Mileage Allowances to Substantiate Automobile Expenses; Correction

Announcement 98–110

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to temporary regulations.

SUMMARY: This document contains a correction to Treasury Decision 8784 (1998–42 I.R.B. 4), which was published in the **Federal Register** on Thursday, October 1, 1998 (63 F.R. 52600) relating to the use of mileage allowances to substantiate automobile business expenses.

DATES: This correction is effective October 1, 1998.

FOR FURTHER INFORMATION CONTACT: Donna Crisalli, (202) 622-4920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of this correction are under section 274 of the Internal Revenue Code.

Need for Correction

As published, T.D. 8784 contains an error which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of the temporary regulations (T.D. 8784), which were the subject of F.R. Doc. 98–26226, is corrected as follows:

§1.274(d)–1T [Corrected]

On page 52601, column 1, §1.274(d)–1T(a)(1) and (2), the last line of the paragraph, the language "guidance, see §1.274(d)–1(a)(1)." is corrected to read "guidance, see §1.274(d)–1(a)(1) and (2).".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

Foundations Status of Certain Organizations

Announcement 98–111

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

G & H Visual and Performing Arts Educational Center, St. Louis, MO
G R E C O M, Richmond, VA
Gainesville Area Aids Project Inc., Gainesville, FL
Gainesville Chess Club Inc., Gainesville, FL
Gainesville Pride Arts Inc., Gainesville, FL
Galen Enterprises Inc., Suffolk, VA
Galena Park Police Auxiliary Association Inc., Galena Park, TX
Galion Area Betterment Commission Inc., Galion, OH
Gallegos Lane Residents Association, Santa Fe, NM
Galveston County Employers for Quality Health Care, Texas City, TX
Gamma Lambda Educational Foundation Inc., Carmel, IN
Gang Alternatives Partnership Inc., Sparks, NV
Gardnermontachusett Childrens Museum Inc., Gardner, MA
Garrison Childrens Education Fund, Garrison, NY
Gay and Lesbian Community Center of Greater Cincinnati Inc., Cincinnati, OH
Gaza American Economic Development Foundation, Columbus, OH
Geared for Life Inc., Birmingham, MI
Geary Foundation Inc., Geary, OK
Generations Adult Day Care Inc., St. Louis, MO
Genesee Region Home Care Association Inc., Rochester, NY
Genesis Center, Manteca, CA
Genesis Housing Corporation, Baltimore, MD
Genesis Rehabilitation Inc., Pittsburgh, PA
George Aiken Ministries Inc., Okeechobee, FL
Georgia Equine Rescue League Ltd., Jersey, GA
Georgia Somali Community Inc., Stone Mountain, GA
Gerald M. Bowers Study Club in Periodontology, Inc., Westminster, MD
Gerald Walker Memorial Scholarship Foundation Inc., Garland, TX
Gift of Life Inc., Landover Hills, MD
Ginger Thomas Broadcasting Corp., St. Thomas, VI
Girls and Boys Against Gangs, San Francisco, CA
Gita in Thought and Action, Palos Heights, IL
Give Them a Second Chance Inc., Plantation, FL
Glendale Educational Opportunity Inc., Glendale, CO
Global Community Inc., New York, NY
Global Concern Inc., Lenexa, KS
Global Ministry Resources, Portland, OR
Global Reconstruction Organization for Kids, Spokane, WA
Global Share, Prescott, AZ
Global Support Connection Inc., New York, NY
Global Youth Resources Organization Inc., Burnsville, MN
Globallove Inc., a Colorado Non-Profit Corporation, Denver, CO
Globe-Link Productions Inc., Miami, FL
Glorias Teensy Weensy Learning Center, Ferriday, LA
Gloucester Pride Stride Committee Inc., Gloucester, MA
God is Moving Inc., Houston, TX
Gods Christian Missionary Service Inc., Rochester, NY
Gods Way for Today Inc., Denver, CO

Golden Child Care, Stafford, TX
Golf for Childrens Charities Inc., Newtown, PA
Good News Gospel Missions Inc., Port St. Lucie, FL
Good Ole Boys, Cincinnati, OH
Good Samaritan Housing Inc., Balm, FL
Good Samaritan Medical Clinic Inc., Roswell, GA
Goodnow Library Foundation Inc., Boston, MA
Gospel Evangelistic Ministries, St. Joseph, MO
Gospel Extended Ministries, Broken Arrow, OK
Gospel of Deliverance Christian Group Home, Sonora, CA
Gospel Wings International Inc., Okanogan, WA
Government and Community Together for Legal Lives Inc., Brooklyn, NY
Grace Restoration Ministries Inc., Thomasville, GA
Grand Ledge Swim Club Inc., Eagle, MI
Grand Ledge Wrestling Club Inc., Lansing, MI
Grand Prairie Rape Crisis Coalition, Grand Prairie, TX
Granite State All-State Shoot Out, Manchester, NH
Grant Day Care Corp., Overland Park, KS
Grant School Community Foundation, San Diego, CA
Grants Pass Childrens Center, Grants Pass, OR
Grassroots Tennis of New Haven Inc., New Haven, CT
Grateful Daycare Team Parenting and Learning Center, Pickens, MS
Gray Foundation, Santa Rosa, CA
Grayson County Fair Association, Sherman, TX
Great Commission Comunications of North Iowa Inc., Mason City, IA
Great Plains Football League Inc., Wichita, KS
Great Pond Mountain Conservation Trust, Orland, ME
Great River Road Arts Coalition Corporation, Prescott, WI
Great Things Incorporated Foundation, St. Louis, MO
Greater Brimingham Fair Housing Center Inc., Brimingham, AL
Greater Boston Athletic Association Inc., Quincy, MA
Greater Cincinnati Earth Angel Cruise Foundation, Cincinnati, OH
Greater Detroit Islamic Alliance, Southfield, MI
Greater Loup Valley Activities Inc., Ord, NE
Greater Provo Open, Provo, UT
Greater Resources and Aids Awareness Community, Kansas City, MO
Greater Rochester Christian Gathering Inc., Rochester, NY
Greater San Diego Chamber of Commerce Foundation, San Diego, CA
Greater Shelby County Ministerial Coalition Inc., Shelbyville, KY
Greater Shreveport Human Relations Commission, Shreveport, LA
Greater Tulsa Luis Palau Crusades Inc., Tulsa, OK
Greater Wauzeka Enterprise Association Incorporated, Wauzeka, WI
Green Bay Swim Club Inc., Green Bay, WI
Green Futures Inc., Assonet, MA
Green Hill K-9 Search & Rescue Inc., Enosburg Falls, VT
Greene & Beyond Inc., South Bend, IN
Greene Youth Athletic Assn. Inc., Greene, ME
Greenville Area Alliance for the Mentally Ill, Greenville, AL
Gretna Community Youth Association Inc., Gretna, NE
Greyhound Rescue Society Inc., Sugar Loaf, NY
Grid Ink CA Nonprofit Corporation, Pittsburgh, PA
Groton Mystic Falcons Youth Football League Inc., Groton, CT

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
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Z—Corporation.

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